Charities In Distress: Governance and Standards of Care In Troubled Times

By: Christina M. Mason and Carolyn R. Caufield

Attorneys advise prudent actions for nonprofit leaders

In times of economic hardship, non-profit organizations confront issues that are unique to their status. Like business entities, charities have responsibilities to their employees, to conduct their activities and to their creditors. But charities also have obligations to their donors and are accountable to the community at large for the use of their assets for charitable purposes, which may impede how those assets are used in responding to financial difficulties. So how does a charity navigate perilous economic waters when its actions are scrutinized and governed by a multiplicity of (potentially conflicting) interests?

Dear Prudence: Standards of Care for Directors and Officers

Of paramount concern to charitable directors and officers is whether they may be held personally liable for decisions, particularly challenging decisions such as reducing staff, borrowing against an endowment or even filing for bankruptcy. Historically, the standard of care that applied to the governing bodies of charitable organizations was rooted in trust law which carries a greater risk of personal liability. However, modern non-profit corporation statutes have attempted to adopt standards of care more closely attuned to the business corporation model.

Each state has adopted its own set of laws governing the conduct of managers of charitable organizations. Although the actual language of each state's law may vary, the principles generally do not. For example, in New York, "[d]irectors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

The actions of directors which have been taken in good faith and with the honest judgment that such actions were in furtherance of the nonprofit's corporate purposes. Directors and officers are required to be "honest," to disclose conflicts of interest and to subordinate their own interests to those of the corporation. The officer or director who complies with the standard of care will not be subjected to personal liability, even if the relevant decision turns out to have been incorrect. The officer or director who complies with appropriate decision making process will not be held accountable for the results of his or her decisions. New York and other states have also limited the liability of uncompensated directors, officers and trustees of most charities. No personal liability will attach unless he or she is guilty of gross negligence or intentional harm.

A director's compliance with the standard of care may be complicated by the interests of donors, creditors and the general public in the activities and assets of charitable organizations. Whether legally binding or not, both the officers and directors of charities must address these sometimes conflicting interests in tapping their endowments and other institutional funds, addressing the claims of creditors and disposing of assets held for charitable purposes.

Swimming Underwater: Drawing on Endowments in Hard Times

States have also adopted rules for managing charitable endowments and other institutional funds. Virtually all states and the District of Columbia have enacted some variant of either the Uniform Management of Institutional Funds Act or the more recent Uniform Prudent Management of Institutional Funds Act, inelegantly referred to as UMIFA and UPMIFA, respectively.

The uniform acts set forth their own standards for directors and officers in managing institutional funds, loosely based on the business judgment and ordinary prudence standards applied more generally to the actions of directors and officers.. UMIFA states that in managing its institutional funds the "governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision." UPMIFA directs that the board shall consider the charitable purposes of the organization and shall manage each fund in good faith and with the care an "ordinarily prudent person in a like position would exercise under similar circumstances." Both statutes enumerate the factors that must be taken into consideration in investing charitable assets and delegating investment authority.

The uniform act applicable in a particular state is key to the latitude the charity has in accessing its endowments. UMIFA is the more restrictive of the two uniform laws and permits a charity to appropriate the net income and so much of the appreciation of the fund over its "historic dollar value" as the board considers prudent. Historic dollar value refers to the aggregate value of all contributions to the fund or funds at the time made. The concept of historic dollar value is intended to preserve the original principal of each gift. Unfortunately, the current stock market woes have left many endowments "under water" -- below historic dollar value. In UMIFA states, this means that only the income is available to charity until the endowment recovers its historic dollar value at a time when other sources of income are likely to be declining. Nothing prevents the terms of the gift instrument from altering the general rule.

Where enacted, UPMIFA eliminates the troublesome notion of historic dollar value and permits a charity to use such amounts of an endowment (consistent with the purposes of the endowment) as the board deems "prudent." In UPMIFA states, charities have the option of using endowment principal even when the value is below historic dollar value. Charities must still consider the duration and preservation of the fund, the purposes of the charity, the effects of inflation and deflation, the charity's other resources and its investment policy. Concern that some organizations would spend down their endowments imprudently led to an optional provision in the draft of UPMIFA which would create a presumption of imprudence if a charity spends in any year more than 7% of the endowment's average value over the previous three years.

Both UMIFA and UPMIFA permit the charity to obtain the consent of the donor or donors either to permit an invasion of principal or to release a restriction on an endowment that would allow its use for the general uses of the organization. However, charities should be cautious and consider whether such a request would jeopardize donor relations and the potential for future fundraising.

UMIFA and UPMIFA also permit a charity to ask a court to release a restriction, but this is may not be a practical solution for temporary financial issues. Under UMIFA, the court must find a restriction to be "obsolete, inappropriate or impracticable" in order to release it. Under UPMIFA, the restriction must be found to be "impractical or wasteful" or to impair "the management or investment of the fund." A court may modify a restriction if, because of circumstances not anticipated by the donor, a modification of the restriction will further the purposes of the fund. In all cases where the written consent of the donor is not available, the attorney general of the state must be given notice of the proceeding or action.

Charities may be able to use their endowments as security for a loan (advantageous in today's low interest rate environment), provided that the loan proceeds are used in a manner consistent with the purpose of the endowment. Some have suggested that a charity may borrow "from" an endowment. However, this would seem to be contrary to the principle of preserving historic dollar value in UMIFA states. Nevertheless, the New York City Opera was able to borrow $23.5 million from its endowment with the approval of the court and the New York attorney general. Even in UPMIFA states, by borrowing from itself, the charity cannot give the endowment the protections a creditor would have. If the charity goes under, the borrowed endowment goes with it. Borrowing from the endowment should not be undertaken without the express consent of the donor or, if the donor is deceased or incompetent, the state attorney general and the court.

None of these rules, except the standard of care, applies to board-restricted funds, or "quasi-endowments." They apply only to funds restricted by one or more donors (including donors giving to an endowment fund based on representations that fund will be restricted in time or purpose). What the board alone has restricted, the board may release and use for its general purposes.

Donors versus Creditors: Who Wins?

A charity also has obligations to its creditors, but not in abrogation of its duty to its donors. Whether a charity is in bankruptcy or state insolvency proceedings, or is simply trying to determine how to pay the bills, state law will determine the rights of creditors to assets held for charitable purposes. However, not all of a charity's assets may be made available to pay the claims of creditors. The analysis under the law of the applicable state turns on whether the assets are held in a separate trust, or quasi-trust, whether the assets are held for specific purposes or, if the charity goes out of business, whether the court should apply principals of equity and determine the further use of assets held for specific purposes.

A trust for the benefit of a charity will not ordinarily be subject to the claims of creditors, unless it can be revoked by the charity or was created by the charity for its own benefit. A trust created by a third party is generally not available to the claims of creditors. If the charity has ceased to exist, the trust will not fail; rather a state court will determine its further and best uses. Relying on these rules, some charities create separate fundraising entities to insulate those assets from the claims of creditors.

Typically, however, an endowment is not legally a charitable trust. Nonetheless, an endowment created by a charity which solicited donors by representing the fund as a permanent fund for specific purposes may be deemed equivalent to a charitable trust and not subject to creditors' claims. Donor intent, in short, trumps creditors' claims where the fund is restricted for a particular purpose.

Board-restricted assets ordinarily will be subject to creditors' claims on the theory that they are revocable and self-settled. Also, to the extent that a debt is within the scope of the purposes of the endowment, some part of the endowment may be available to the creditor.

A Moral Minefield: the Sale of Assets Held for Charitable Purposes

A charity also has obligations to the general public which may dictate the terms on which it makes use of its assets in times of financial hardship. As several institutions have recently discovered, the local community and professional groups may also have a say in whether the asset can be sold and for what purposes. For example, the National Academy Museum sold works of art in order to meet operating expenses, thereby running afoul of the guidelines of the Association of Art Museum Directors, which require that the proceeds of art sales be used solely for new acquisitions. The New York Public Library sold Asher B. Durand's "Kindred Spirits" for Alice Walton's museum in Arkansas, despite the painting's deep connection with New York, generating criticism. Faced with having to sell key assets, a governing board must balance these other concerns against serving the broader purpose of the institution as a whole, particularly where the alternative may be bankruptcy, dissolution or severe curtailment of its activities.

Conclusions and Recommendations

Responsibility for addressing a charity's financial difficulties lies with the directors, who must make a determination of what can be done as well as what should be done. Directors and officers should be familiar with applicable state laws defining the obligations of charities' directors and officers, and the rights of donors and creditors, and with community and professional sensitivities. Strong governance practices should be in place to insure honesty and the integrity of decisions. Directors and officers, particularly those who are compensated, should be insured against the prospect of personal liability. Obtaining the opinions of counsel may be prudent when confronting decisions that affect labor and employment, the legal rights of donors and creditors, employee benefits issues or filing for bankruptcy. Inquiries to the state attorney general may provide guidance on what actions will be deemed acceptable under the law and to the community. As a last resort, the organization may be forced to seek court protection and guidance, including bankruptcy or dissolution. However, with adequate governance practices and attention to the relevant standard of care, whatever decisions are made will be prudent and no director or officer will incur personal liability.

Christina M. Mason is a partner at **Kelley Drye & Warren LLP**. She focuses on trusts and estates, tax, estate planning, real estate and private foundations and other charitable organizations. Ms. Mason can be reached at **cmason@kelleydrye.com.**

Carolyn R. Caufield is a partner at **Kelley Drye & Warren LLP**. She focuses on trusts and estates, closely held businesses, estate and gift tax, and fiduciary matters including income tax. Ms. Caufield can be reached at **ccaufield@kelleydrye.com.**